

Risks to the Long-Term Stability of the Euro

As part of our 2004 Summer Fellowship Program, AIER invited Anna Schwartz to give a talk to the program's participants. Schwartz is a Research Associate at the National Bureau of Economic Research and the co-author, with Milton Friedman, of A Monetary History of the United States, 1867-1960 (1963), one of the most influential economics books of the 20th century. She presented a paper on the future of the euro. She believes there are ample grounds for immediate and long-range concerns with respect to the prospects for the stability of the euro's purchasing power. An abridged version of her paper is presented below.

In the centuries for which there is a record of currencies that had brief or longer periods of existence in varied geographical areas it was unusual for a new currency to quickly win acceptance. Before a new currency became acceptable in settlement of transactions, it had to prove that it merited a reputation first and foremost of long-term stability of value. The euro seems to be an exception to this rule. In 2002 without demurral the residents of the 12 members of the European Monetary Union (EMU) replaced their national currencies with the untested euro banknotes and coins.

Unquestionably the explanation for this behavior by this subset of the European public was the belief that the euro was not a new currency but the facsimile of the Deutsche mark, the preeminent national currency among the EMU countries. The architects of the EMU deliberately set out to create this aura for the euro. On the one hand, they wanted to convince the German public that giving up the mark would be costless for them. On the other hand, they wanted to convince the public in the other eleven countries of the euro area that they were acquiring a currency for which their abandoned national currencies were no match.

To achieve these objectives the European Council—the heads of government and foreign ministers of the member states and the president of the European Commission (the executive body of the European Union, or EU)—signed the

Maastricht Treaty in February 1992. The Treaty prescribed five convergence criteria that 15 member states of the EU had to meet to enter the separate EMU in January 1999. The criteria specified that (1) the public budget deficit be below three percent of gross domestic product (GDP); (2) the public debt be less than 60 percent of GDP; (3) the inflation rate be within 1.5 percentage points of that of the three EU countries with the lowest inflation rates; (4) the long-term interest rates be within two percent of the rate of the three countries in the EU with the lowest interest rates; (5) there be no nominal exchange rate movements for two years outside the EU margins in a ± 2.25 percent range around fixed bilateral rates. The criteria imposed strict fiscal rules before the actual adoption of the euro in January 1999, initially as a unit of account only.

By January 1999, eleven countries, with some fudging, had met the convergence criteria and formed the EMU, or euro area; they were joined by Greece in 2001. Three EU members (Denmark, Sweden, and the United Kingdom) either did not meet the criteria or chose to remain outside the euro area. The ongoing enlargement of the EU membership is creating new candidates for the EMU. On May 1, 2004, ten countries from Eastern Europe, the so-called “accession” countries, joined the EU: Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland,

Slovakia, and Slovenia. They are not yet part of the EMU and the Euro Area, but may qualify as they satisfy the convergence criteria.

The European Central Bank (ECB)—established in Frankfurt to demonstrate by its location its identification with the Bundesbank—began operations in 1999. Its independence was guaranteed by the Maastricht Treaty, and its mandate, like that of the Bundesbank—“to safeguard the currency”—was to maintain medium-term price stability, which it defined as an increase under two percent from one year to the next in the harmonized index of consumer prices of the member states. The single goal of price stability and reliance on a monetary growth indicator to achieve it again served to link the ECB as an inflation fighter to the style of its Bundesbank predecessor.

To solidify the commitment to fiscal discipline once the euro was adopted in January 1999, the member states also agreed to observe fiscal rules set by the Stability and Growth Pact. Namely, national budget deficits would be limited to three percent of GDP and government budgets would be kept close to balance or in surplus.

Moreover, the architects of the EMU intended that no relaxation of fiscal discipline be countenanced in the future. The Maastricht Treaty conditions for membership in the Euro Area will have to be met by the ten new members of the EU and any other countries that may hope to join in the future. Not only EMU members but all current and future members of the broader EU area (and currently there are 13 non-EMU EU countries) are required to satisfy the terms of the Stability and Growth Pact.

There can be no doubt that these fiscal requirements, and the price stability mandate of the European Central Bank, were designed to hedge the euro against lax monetary policy and profligate fiscal behavior by the governments of member states. The aim was to ensure the currency's reputation as a bulwark for maintaining price stability over the medium term.

Yet despite the architects' efforts to erect barriers to loose monetary and fiscal

policy in the EMU, risks are rising that the barriers will be circumvented with predictable baleful consequences for the euro. The problem resides in the design. The monetary union provides for an institution that centralizes and coordinates monetary policy but leaves fiscal policy to the decentralized and uncoordinated decisions of the member national governments. The governments have yielded their monetary sovereignty to the ECB and accepted a fixed exchange rate, but retain independent spending and taxing powers. And the rules that were established to limit the exercise of fiscal independence have proved to be porous.

There are clear indications of a disposition among leading members of the EMU to inflate their way out of trouble. Attempts by national governments to get the ECB to modify its position on curbing inflation have thus far been resisted. But the long-run problem for the ECB is that monetary union was something that the political elite of France and Germany long had sought. It was not a change that voters demanded. If farmers and organized labor come to believe that monetary union that delivers tight monetary and fiscal performance hurts their interests, will they oppose policies that erode the purchasing power of the euro?

One explanation for rejection of the euro by Swedish voters in a 2003 referendum was that voters were concerned that adhering to the EU deficit rule would have compelled Sweden to cut back its social welfare benefits. If true, the implication is that public support for a credible euro is weak. The euro, even if unsound, will exist only if the customary benefits system is undisturbed.

In what follows, I discuss the forces that are poised to jeopardize the value of the euro and the forces that might uphold it. The ultimate question is the viability of a monetary union with centralized monetary policy and decentralized fiscal policy.

Monetary Policy Guidelines Disputed

The main complaint by critics of the ECB, who are by no means limited to euro member countries, is that its focus on price stability has come at the expense of output stability. It has been charged with ignoring the need to lower interest rates when the euro area has experienced recession. As a result, the ECB's monetary policy allegedly has been contractionary, and Germany in particular has suffered deflation. To satisfy the critics, the ECB would have to be more accommodative.

Other critics say that the ECB claims to use the M3 money supply as a policy

guide but has actually failed to do so, therefore it should abandon it. Unfortunately, this would encourage the ECB to change its procedure for formulating monetary policy without necessarily changing the outcome. Still other complaints focus on the ECB's limited accountability and transparency, and its weak communications strategy.

Of all the misgivings concerning the ECB, however, the most serious is the one whose aim is to weaken its commitment to non-inflationary monetary policy. Chinks in the ECB's armor may be driven by the members of its Governing Council or the public in the Euro Area.

The Governing Council is composed of two groups: the governors of the national central banks of the member countries and the ECB Executive Board. The former outnumber the latter, 12 to six. The bank governors judge monetary policy in terms of its effects on their national situations. The Executive Board presumably adopts monetary policy to fit the union as a whole. Only in extreme circumstances that would presage the dissolution of the EMU would a movement by the bank governors to overrule the Executive Board be conceivable. They would have to believe that the ECB's monetary strategy could not be reconciled with national concerns that in their judgment took precedence. A dyspeptic view on such a contingency was expressed in a report that "play[ed] up the dangers to the ECB of being overwhelmed by the combined weight of politically untrustworthy Euro Area governments."

As stalwart as the ECB may be in defending its commitment, its performance in a democracy is ultimately determined by the preferences of voters. Are residents of the countries in the euro area resolute supporters of price stability? It is commonly believed that the reason the German public prizes price stability is the imprint of the historical memory of the destructive experience of two post-war hyperinflations. But what if their political leaders argue that other goals are more important? And is the public of other member countries as keen for stable prices as the German public is reputed to be?

Another uncertainty is the difference in the conduct of the ECB that the replacement of its president may occasion. Before the new president, Jean-Claude Trichet of France, took office last year, he told the European Parliament that he plans to be flexible by aiming for price stability while assessing the state of the economy with realism and pragmatism. It is difficult to interpret this language in

relation to the ECB's mandate. He defended the inviolability of the limit on government budget deficits, and expressed skepticism that deficits improve economic growth during slumps. He opposed allowing any of the ten new EU countries from Eastern Europe to adopt the euro before satisfying the EMU's criteria on growth, inflation, and exchange rate stability. He is a more adept communicator than his predecessor, Wim Duisenberg of the Netherlands, portending success in this role, but he also has rejected moves to enhance the transparency of the ECB. There may well be an improvement in the public relations aspects of the ECB under Trichet, but it is more significant that the monetary policy under a new president may change. Whether the departure is in the direction of greater ease remains to be seen.

The ECB itself apparently is not immune to pressures to tolerate higher inflation, however minimal the increase. In 2003, it changed its target to "below but close to two percent" from the previous "under two percent." The change was interpreted as a signal of the ECB's willingness to be flexible.

The one development that might reduce the immediate ongoing pressure on the ECB to be more accommodating is a robust economic recovery in Western Europe sooner rather than later.

Stability and Growth Pact Assailed

The Pact was adopted to prevent profligate government spending that would undermine the euro. Yet France and Germany flouted the Pact's deficit rule in 2002 and 2003 and will do so again this year. The French budget minister, moreover, has announced that the deficit is likely to breach the cap until 2006, and Germany's deficit probably will, too. Smaller countries with balanced budgets responded by demanding large fines for the violators. Germany and France, for their part, lobbied the European Commission, the EU's executive body, to invoke a clause of the Maastricht Treaty that overrides the deficit rule because of "special" circumstances and thus absolve them from the obligation to pay a fine.

Late last year the European Commission recommended disciplinary action against France and Germany. However, the finance ministers of the 12 euro countries overrode the Commission, thereby allowing the two violators to go unpunished for consistently breaking the budget rules. In the latest development, this summer the European Court of Justice, Europe's highest court, ruled that the 12 countries had acted illegally in overruling the Commission.

Clearly this dispute has tested the willingness of members to abide by the budget rules and the ability of the European Commission to enforce those rules. It has also increased the pressure to reassess or rewrite the rulebook, *i.e.*, the Stability and Growth Pact. The effort to ignore France's and Germany's deficit violations also sets a bad example for new EU members Poland and Hungary, whose budgets are bloated.

Another budget rule may soon be broken: French public debt has soared and this year may exceed the ceiling of 60 percent of GDP. In addition, state intervention to bail out companies in trouble has been a recurring practice in France. Objections to one such rescue action were raised by the European Commission. France responded by changing the terms of the rescue so that it did not technically breach the EU's state-aid laws. But the maneuver did nothing to curtail government spending. Such episodes give the impression of play-acting by the bureaucrats and the governments without substantive change in the offending behavior.

The ECB has warned France and Germany that widening deficits defeat cutting rates to stimulate the economy. Lucas Papademos, the ECB's vice president, reminded them to honor the three percent deficit cap as well as an earlier promise to cut deficits each year. Otherwise, he said, the euro would be at risk. The president of the European Commission, Romano Prodi, was skeptical that higher deficits and debt had helped countries reverse the economic slowdown since 2001.

The Pact, according to many economists, is too rigid. Prodi once called it "stupid," because of its lack of flexibility. Last year the Commission proposed that countries should be allowed to break the deficit limit rule when their economies show negative growth rates. Currently, this is permitted only when economies contract by two percent or more. The Commission also proposed that it should play a bigger role in establishing which countries are in breach of the Pact. Whether the deficit was excessive would be determined by the size of the overall level of public debt.

Opponents of the Pact argue that it is one-sided in favor of stability and neglects the equal importance of growth. In view of the current slump, they urge that growth should be the chief emphasis.

A different perspective on the Pact highlights a flaw. The Pact's reliance on a deficit/GDP ratio or even a cyclically-adjusted ratio is faulty because the ratio's effects on economic performance are ambiguous. The underlying spending and tax

structures, their impacts, and the key fiscal policy choices they imply are more significant than the deficit measure. This comment does not, however, challenge the goal of fiscal responsibility, which is at the heart of the Pact.

One observer remarks that the Pact will not last. "It is so evidently a stop-gap, negative measure. . ."

No one yet has proposed a revised version of the Pact to deal with the glaring discrepancy between reality and the rule the Pact imposes. One suggestion is to regard the three percent budget deficit cap as a goal rather than an absolute limit. Instead, the deficit would be averaged over several years.

Others have suggested that governments will resort to fudges in order to legitimize increased government spending when budget deficits already exceed the Pact's cap. They might treat the new spending as "off-budget" and thus not adding to official budget deficits.

The question remains whether the residents of the euro area will accept subterfuges as certifying the euro's soundness.

Need for Reform of Member State Benefit Programs

The absence of restraint in current government expenditure in important EU countries coupled with efforts to persuade the ECB to be accommodative casts a shadow over expectations that the euro is a currency that will provide stable long-term value. The outlook for the euro is further clouded by the immense financial burdens governments will bear during the coming half century if they honor their future unfunded commitments to pay generous pensions and health care expenses for aging populations.

The pay-as-you-go system in the euro area is hostage to the ratio of the working population to the retired population. The demographics in the area project a declining proportion of working age people and a rising proportion of older people. This imbalance means that the contributions of workers will not suffice to pay benefits to increasing numbers of the retired. Unless these programs are reformed either by reducing promised benefits or raising taxes, or the public fisc is enhanced, deficits for governments will loom.

The euro area countries, like other advanced countries, can, however, adopt policies that would offset the adverse fiscal consequences of aging. Promotion of labor migration from countries with younger populations to those with faster-aging populations would also mitigate fiscal problems. The number of immigrants that would need to be admitted to the euro-area countries to redress the imbalance in

the age distribution of their population, however, is probably higher than politically and economically feasible. Reform efforts in France and Germany to improve the financial soundness of public pension systems unfortunately have also been limited, and even so, unpopular. The post-World War II baby boom generation will age in coming decades and become pensioners. The ratio of the population aged 65 and older to the population 20-64 will double in the euro area between 2000 and 2050.

The fiscal consequence of unfunded systems, as in many EU countries, is that concurrent workers are the only source of finance for public pensions of concurrent retirees. The liabilities of current pension schemes are estimated to peak over the next 50 years at four to five percent of GDP in the EU.

Contemplated reforms to domestic pension systems include some to reduce claims of current and prospective retirees on future output, and some to counter the projected slowdown in growth of output by improving labor market performance. The former set of reforms might extend the retirement age or contribution period to qualify for a full pension. It has been estimated that this set of reforms would roughly reduce by half projected fiscal deficits by 2050.

The second set of reforms to improve growth prospects is particularly appropriate for the euro area. The aim would be to increase employment of people aged 55 to 64 through higher participation and lower unemployment. Raising female participation rates would also be a desirable reform as would removal of restrictions on use of part-timers. Labor market reforms would reduce the effect of aging on GDP growth with the result of increasing government revenues and of moderating future pension expenditures particularly in Germany, France, and Italy. These reforms would need to be coordinated with modification of existing disincentives that current taxes and transfers exert on labor force participation by older workers.

Health care costs will also rise as the population ages, along with pension costs, further impacting public finances. The ratio of health costs for the elderly compared with those for younger people is estimated to be three-to-one in the EU. Public health expenditures could increase by two to three percent of GDP in advanced countries over the next 50 years as a result of aging. Absent reforms that would expand revenues or contain spending, public debt as a share of euro area GDP could increase by 150 percent by 2050.

In the euro area the move in the 1990s toward economic and monetary union was marked by a sharp reduction in expenditure by governments with relatively high levels of debt. The reductions in fiscal deficits since 1993 occurred mainly in response to the formal deficit and debt rules of the Maastricht Treaty and the subsequent Stability and Growth Pact, although Finland and the Netherlands relied on expenditure limits whereby overruns had to be offset either by cuts in other expenditures or revenue increases. Fiscal discipline seemed a commitment of the EMU when the euro was launched in 1999.

Recent developments raise a question concerning the strength and durability of the commitment, with inevitable repercussions on the market's confidence in the euro's suitability to serve as a store of value. An even greater challenge for the euro will come from the fiscal pressures on the EMU countries associated with the predictable swelling of liabilities for public pension and health care systems over the next half century. The choice for them will be between maintaining fiscal discipline by timely reforms or abandoning monetary discipline by increasing the euro money supply to finance the requisite expenditures.

Enlargement of EU Membership

The ten countries that joined the EU this May and any subsequent members have to satisfy economic, structural, and institutional requirements. Compliance has been weak with respect to privatization of state-owned enterprises, achieving less government direction of national economies, and wider reliance on markets to allocate scarce resources. Monopolies and trade restrictions still have to be reduced. Improved labor market flexibility also would be a sign of progress in both the original and the accession countries.

To eventually join the EMU and adopt the euro, the ten new EU countries must have national central banks that are fully independent, forswear direct financing of the general government, agree to liberalization of capital flows, and participate in TARGET, the EU-wide payments system for euros. They must also become members of the Exchange Rate Mechanism, a system designed to reduce exchange rate variability, for at least two years.

Among the criticisms that have emerged from the enlargement of the EU, it has been noted that, except for Poland, the ten new entrants have small populations. All of them have large farm sectors. Their government operations are inefficient and corruption is a problem. They

probably will demand and receive EU economic-development subsidies.

There is a large disparity between the GDP of the new member countries and the older EU members. In 2002, GDP per capita in the EU (prior to expansion) averaged 24,094 euros, versus only 5,750 euros for residents of the new members. Comparing the new members with the separate euro area, the divergence is also large: average per capita GDP is 44 percent less in terms of purchasing power parity, and 22 percent less in terms of current exchange rates. Convergence will not be quickly achieved. In addition, structural reforms noted above, including the rehabilitation of the banking and financial systems, are urgently needed in the transition countries.

Fiscal deficits in four of the largest new member states (Czech Republic, Hungary, Poland, Slovakia) have spun out of control in recent years. Hungary's budget deficit in 2002 was over nine percent of GDP, the highest ratio in Europe, the Czech Republic's was 7.3 percent, and Poland's was 5.8 percent. Slovakia has pursued an austerity regime to restore budgetary balance in the last reported year. But in general, political opposition to cuts in public spending or tax increases is strong. In the Czech Republic, the fiscal problem arose from the government's attempt to recapitalize insolvent commercial banks. To recapitalize an insolvent financial system by non-inflationary means, a fiscal authority itself should be solvent.

These same countries suffered declines in net new foreign investment in recent years, reflecting the world economic slowdown. Indeed, capital has been flowing out of Hungary. Yet these countries have continued to spend freely on highways, bridges, and other public works. Substantial public sector wage increases in the region, moreover, have shifted low-cost manufacturing jobs to the east, to Romania and Bulgaria.

The EMU in its present configuration is not a union of equals. That condition will only grow worse with the addition of the ten new EU countries to the monetary union. They are a heterogeneous group of countries, whether measured in terms of

per capita GDP, financing requirements, or commitment to monetary and fiscal non-inflationary policies. The absence of cohesion in such a currency union raises the probability of disaffection by some members. Going it alone will seem more appealing to them than remaining in the union, even if provisions for exit do not exist.

Would the euro survive political disintegration? It is pertinent to remember how fast a monetary union may collapse after political dissolution. Two currencies that did not survive are the Austro-Hungarian crown after the political breakup of Austria and Hungary in 1918 and the Soviet ruble after the breakup of the Soviet Union.

Conclusion

Jean-Claude Trichet, the new president of the European Central Bank, has remarked that "confidence is of the essence in the present situation. Confidence in our currency, confidence in its capacity to be good store of value, confidence in its medium and long-term stability, confidence in the capacity of the European Central Bank and the Eurosystem as a whole to deliver price stability." (Trichet, "The Euro and the Monetary Union," *Atlantic Economic Journal*, September 2002).

To merit such confidence, the grounds for immediate and long-range concerns with regard to the prospects of the euro would need to be allayed. The immediate concerns arise from the pressures on the ECB to be more accommodative and the drive to weaken the Stability and Growth Pact. The long-range concerns arise from the spending obligations the member governments have assumed to provide pensions and health care to their aging populations for the next half-century, and the recent enlargement of the EU to include ten states that are less economically and institutionally advanced than the pre-enlargement group of member states. The outlook is for greater spending by governments than their projected resources, unless forces not now visible will strengthen the resolve of political leaders to serve the cause of a sound euro. □

PRICE OF GOLD

	2002 Sep. 12	2003 Sep. 11	— 2004 —	
			Sep. 2	Sep. 9
Final fixing in London	\$318.85	\$376.30	\$406.10	\$396.30

Research Reports (ISSN 0034-5407) (USPS 311-190) is published twice a month at Great Barrington, Massachusetts 01230 by American Institute for Economic Research, a nonprofit, scientific, educational, and charitable organization. Periodical postage paid at Great Barrington, Massachusetts 01230. Sustaining memberships: \$16 per quarter or \$59 per year. POSTMASTER: Send address changes to **Research Reports**, American Institute for Economic Research, Great Barrington, Massachusetts 01230.